

with the net COE and cable and wire investment plus depreciation and operating expenses is the study area's total unseparated loop costs on which the High Cost Loop Support is based.⁴⁵ Ameritech has shown however, that the book retirement of an asset does not have an impact on the net investment because both the asset and accumulated depreciation balances are reduced by the same amount. Similarly, there is no impact on remaining life depreciation expense because the book retirement impacts the plant balance and depreciation rate in an offsetting manner, i.e. a lower plant balance increases the depreciation rate through a reduction in the accumulated depreciation reserve; the higher depreciation rate is applied to a lower plant balance with a net effect of similar depreciation expense amount.⁴⁶

With respect to the future determination of High Cost Loop Fund Support for non-rural LECs, the Commission has adopted, but not yet implemented the use of a proxy model based on forward-looking economic cost contradistinguished from embedded costs, where embedded costs mean 'booked' or 'reported' costs, i.e. those costs represented on a company's CPR. Specifically, the use of embedded or reported costs was rejected. The FCC has recently initiated a proceeding to determine the input values used to estimate the forward-looking costs for High Cost Loop Fund Support.⁴⁷ In the USF Notice, the FCC has proposed to use embedded costs publicly available in the Automated Reporting and Management Information System (ARMIS) as a starting point in the determination of the input values for plant specific operations expenses. Specifically, the FCC proposes to use booked expense to current investment, adjusted to

⁴⁴ See Ameritech Response at 15-16.

⁴⁵ See C.F.R. Section 36.621, Study area total unseparated loop cost.

⁴⁶ See Ameritech's Response at 12-14; See also Bell Atlantic Response at Exhibit 5, Affidavit of Ronald E. White, PH.D.

reflect forward looking costs.⁴⁸ This is the only instance where the FCC proposes to use embedded costs as a starting point in the estimation of forward-looking costs. Any alleged overstatement of plant balances would have the effect of lower plant specific operations expense factors, resulting in lower costs per loop and less entitlement to fund support. As a result, there is no negative ratepayer implications of any alleged plant overstatement.

With respect to payments into the High Cost Loop Fund Support, revenues are the sole basis on which the payments are made.⁴⁹ As a result, CPRs or plant balances have no impact on such payments.

Similarly with respect to the pricing of unbundled elements, there is no impact associated with any alleged property record discrepancies because the Commission adopted Total Element Long Run Incremental Costs (TELRICs) pricing. TELRIC pricing is based upon the cost of operating a hypothetical network built with the most efficient technology available, using forward-looking long run economic costs. The use of embedded costs was specifically excluded as a cost measure to be included in the forward-looking cost methodology.⁵⁰ As a result, in Ameritech's review of its cost procedures and methodologies, only two instances were found where cost factors rely on investment balances from accounting records - maintenance factors and ad valorem tax

⁴⁷ See In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45; Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, CC Docket No. 97-160, Further Notice of Proposed Rulemaking, released May 28, 1999, "USF Notice".

⁴⁸ See USF Notice at Paras. 203-211.

⁴⁹ See C.F.R. Section 54.709(a), Computations of required contributions to universal service support mechanisms; See also FCC Form 457, Universal Service Worksheet; See also Changes to the Board of Directors of the National Exchange and Order and Second Order on Reconsideration, CC Docket Nos. 97-21, 96-45, released July 18, 1997 at Para. 843.

⁵⁰ See In the Matter of Implementation of the Local Competition Provisions the Telecommunications Act of 1996, CC Docket No. 96-98, Order on Reconsideration, released September 27, 1996 at Paras. 679-712; See also Ameritech Response at 15-16. Of course the validity of the Commissions approach is currently pending before the 8th Circuit Court of Appeals. See Iowa Utilities Board vs FCC (99-3321 and consolidated cases).

factors. In both instances, any alleged overstatement of plant balances result in a smaller cost factor and lower annual costs, with no resultant adverse impact on any customer rates.⁵¹

Finally, any alleged property record discrepancies would have no impact of the merits of the pending “takings” claims. As the Commission is well aware, a number of incumbent LECs, including Ameritech, are challenging the TELRIC rules on a number of grounds, including the complete exclusion of any actual embedded costs. The incumbents have argued in the Eighth Circuit Court of Appeals that “cost” must be read to include all of an ILEC’s actual costs in order to avoid an uncompensated taking. Because Section 251(c)(3) authorizes CLECs to effect a physical occupation of the ILEC’s network, the mandatory leasing of UNEs constitutes a per se taking subject to the Just Compensation Clause of the Fifth Amendment. The principle that statutes must be read, if possible, to prevent an insufficiently compensated taking dictates an interpretation of “cost” in Section 252 (d)(1)(A)(i) that includes all on an ILEC’s costs, including embedded or “booked” costs. Without recovery of such costs, there can be no return on investment, and, without a return on investment, compensation falls below the constitutionally required minimum.

Briefing and oral argument have been completed on this “takings” claim. Significantly, in defending its forward-looking approach the Commission did not justify its rule on grounds that it was somehow concerned that historical cost methodologies, or property record issues, would necessarily create rate-base issues. This is not surprising since the Commission, prior to its TELRIC rules, had itself for many years relied on the

⁵¹ See Ameritech Response at 16. Any shared and common cost model that uses the ratio of expenses to investment in the determination of factors would have the same result from any alleged overstatement of plant balances. Namely, a smaller cost factor and lower annual costs, with no adverse impact on any customer rates.

original cost principle of ratemaking. Therefore, the accuracy of a particular property record is a separate, and irrelevant, issue to the question of whether the Commission's TELRIC rules constitute an unconstitutional taking or whether the Commission's interpretation and implementation of the pricing provisions of the 1996 Act are otherwise unlawful.

In sum, any alleged property record discrepancies have no adverse impact on either the determination or payments of universal service support or the pricing of unbundled network elements; and are irrelevant to the merits of the "takings" claim.

Issue 10: Any other issue or issues pertinent to the audit reports or the company responses. These issues may include but are not limited to: (1) the benefits of compliance with our rules, as well as the consistency of these rules with other statutory and regulatory policies; (2) the reasonableness of the auditors' interpretations of the CPR requirements; (3) the history and consistency of the FCC's procedure and enforcement of these requirements; and, (4) what other federal and state agencies do and what Generally Accepted Accounting Principles (GAAP) requires to ensure the accuracy of books and records.

The benefits of compliance with the Commission's CPR rules are minimal, if any, given that Ameritech is under no-sharing price caps. There are no statutory or regulatory policies that require the level of detail carriers are required to maintain in their CPRs.

Nearly 450 of the 1,224 items sampled, or over one third, were under \$2,000 (See Arthur Andersen Declaration at Page 16). Micromanagement at such a level evidenced by the CPR rules is inconsistent with the pro-competitive deregulatory policy framework established in the Telecommunications Act of 1996.

The auditors interpretation of the CPR rules with respect to the specific location of an item within a specific bay and shelf is overly narrow and not supported by the CPR

rules. Nowhere in the Commission's rules is location defined to be a specific bay or shelf within the central office.⁵² The Audit Report alleges that 23.3 percent of Ameritech's records are seriously deficient. Of this percent, 9.9 percent were physically verified by ASD within the central office, but located in a different bay or shelf than that specified on the CPR. Ameritech submits that location of an item within a central office is fully consistent with the Commission's CPR rules and Ameritech's Basic Property Record (BPR).⁵³

With respect to the history of the CPR requirements, ASD's enforcement of the CPR rules in these audits is unprecedented on the scale undertaken and untimely given that there is no ratepayer impact.

With respect to the requirements of other federal and state agencies and GAAP, Arthur Andersen LLP was engaged in July of 1998 to examine the accounting rules and regulations in light of the changing regulatory requirements emanating from the 1996 Telecommunications Act and the changing competitive environment with a view towards establishing streamlining opportunities and establishing a blueprint for both the streamlining and elimination of unnecessary regulation (See Arthur Andersen Declaration at Pages 14-16). As part of this examination, information was obtained and comparisons made between the regulations of the FCC and other industries, both regulated and nonregulated. The singular key finding of this benchmarking effort showed that the level of detail required by the FCC is excessive and unnecessary compared to the requirements of GAAP and other industries. For example, the Federal Energy Regulatory Commission has initiated simplification of the property record rules for natural gas, water, oil and

⁵² See C.F.R. Section 32.2000(e) and (f).

⁵³ See Ameritech Response at Page 7; See also GTE Motion for a Declaratory Ruling on Asset Verification, May 13, 1998 at Page 6, Arthur Andersen LLP letter to Mr. Marvin Gentry, FCC Audits Branch of March 24, 1997; SBC Response at Page 25; Bell Atlantic Response at Page 21-22.

electric companies despite the fact that such companies continue to be regulated under cost of service regulation.⁵⁴

Finally, with respect to the audit report's conclusion that Ameritech has a "longstanding" and "deeply ingrained" recordkeeping problem, Ameritech submits that this conclusion does not withstand scrutiny. Specifically, the preliminary conclusion of the ASD for a similar audit conducted in 1994 at Ameritech was that nothing led the auditors to conclude that Ameritech was not in compliance with the Commission's CPR rules.⁵⁵ Of the COE assets tested at Ameritech-Illinois (\$29 M or 17 percent of the total COE asset balance), only 3 percent of the records were alleged to be deficient.⁵⁶

This is hardly an indication of a "longstanding" and "deeply ingrained" problem.

III. CONCLUSION

Contrary to the conclusions and recommendations in the ASD's Audit Report, Ameritech's CPR is not deficient in any material respect with the Commission's CPR rules. Ameritech's and Arthur Andersen's review of the Audit Report show that the results and conclusions cannot be relied upon to form an opinion on the fair presentation of Ameritech's assets, and the recommendations to engage an independent firm to conduct a one hundred percent inventory of central office equipment (COE) and write-off \$566.7 M of COE investment is unwarranted and premature.

There has been no adverse impact on Ameritech's customers and there is no possible basis for any reduction of Ameritech's current rates. The Audit Report cannot be

⁵⁴ See Arthur Andersen Declaration at Page 15.

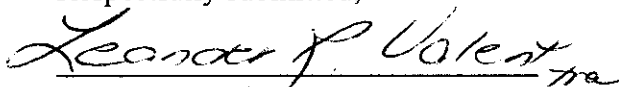
⁵⁵ See Ameritech Response at Page 3; See also letter of Mr. Rudolph Bruno, FCC Accounting and Audits, of November 9, 1994 to Mr. Anthony Alessi of Ameritech at Page 5.

⁵⁶ See letter of Ms. Robin Gleason to Mr. Bruno of December 12, 1994, Audit of Ameritech's Basic Property Records. The deficiency consisted of an inadequate description on the CPR and the absence of a serial number on the equipment. Ameritech maintained, and continues to maintain, that this deficiency did not constitute a CPR compliance infraction because manufacturers provide Ameritech supplemental information on the equipment that can be matched with the equipment description on the CPR record.

relied on by the Commission with respect to any future action involving Ameritech's rates.

While Ameritech understands the Commission's need to create a full public record in this proceeding, it submits that the Commission should expeditiously conclude its inquiry and focus its resources on simplifying and streamlining the CPR rules in the spirit of the pro-competitive and deregulatory framework envisioned in the Telecommunications Act of 1996.

Respectfully submitted,

A handwritten signature in cursive script, reading "Leander R. Valent", with a horizontal line underneath it.

Leander R. Valent

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September 23, 1999

DECLARATION OF CARL R. GEPPERT

I, CARL R. GEPPERT, declare that:

I am a Certified Public Accountant and a partner of Arthur Andersen LLP. My business address is 1225 17th Street, Suite 3100, Denver, Colorado 80202. Andersen Worldwide, with over 100,000 people, provides professional services to clients through member firms in 361 locations in 76 countries. It consists of Arthur Andersen ("AA") for audit, tax, business advisory and specialty consulting services and Andersen Consulting for global management and technology consulting. I am a member of a group at AA that provides audit, tax and consulting services to clients in the communications industry.

During my 19-year career, I have been almost exclusively involved in financial, regulatory and cost accounting matters in the telecommunications and utilities industries. I have served as an auditor for and consultant to clients in the telecommunications industry and currently direct my firm's telecommunications industry practice in the areas of regulatory accounting, auditing and consulting. I am our Firm's representative on the Telecommunications Subcommittee of the Public Utilities Committee of the AICPA.

PURPOSE AND SCOPE OF DECLARATION

This declaration will address certain issues for investigation raised in the Federal Communications Commission ("FCC") Notice of Inquiry¹ and the related Public Notice² released by the Common Carrier Bureau's ("Bureau") Accounting Safeguards Division ("ASD") on April 7, 1999. The Notice of Inquiry and Public Notice relate to the ASD's audit of the continuing property records ("CPRs") of hardwired central office equipment ("COE") at Ameritech. The results of such audit, together with the Company's comments, were publicly released on March 12, 1999.³

Specifically, I will address the following issues raised in the Notice of Inquiry:

Issue 1: The validity and reasonableness of the statistical sampling methodologies used by the auditors, specifically the adequacy and completeness of the audit procedures performed by the ASD related to the physical verification of

¹ *In the Matter of Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit*, Notice of Inquiry, CC Docket No. 99-117, FCC 99-69 (rel. April 7, 1999), [hereinafter Notice of Inquiry]; DA 99-072, rel. June 2, 1999; DA 99-1321, rel. July 2, 1999; DA 99-1855, rel. September 10, 1999.

² *The Accounting Safeguards Division Releases Information Concerning Audit Procedures for Considering Requests by the Regional Bell Companies to Reclassify or "Rescore" Field Audit Findings of their Continuing Property Records*, Public Notice, DA 99-668 (rel. April 7, 1999), [hereinafter Public Notice].

³ *Audit of the Continuing Property Records of Ameritech Telephone Operating Companies - As of July 31, 1997* (rel. March 12, 1999), [hereinafter Audit Report].

hardwired equipment and the propriety of the ASD's recommendations based on the results of the above audit procedures.

Issue 2: The validity and reasonableness of the methodology used by the Bureau's auditors in determining whether to re-score or to modify a finding from its field audit that equipment was "not found."

Issue 10: Other issues pertinent to the audit reports, including (1) the benefits of compliance with the FCC's rules, as well as the consistency of these rules with other statutory and regulatory policies; (2) the reasonableness of the auditors' interpretations of the CPR requirements; and (3) what other federal and state agencies do and what Generally Accepted Accounting Principles ("GAAP") requires to ensure the accuracy of books and records.

In summary, the following key points should be highlighted:

- Sufficiency of the ASD's Audit Procedures -- the ASD's audit procedures were deficient with respect to the use of generally accepted auditing standards ("GAAS") and do not provide a reasonable basis for rendering an opinion as to the fair presentation, in all material respects, of Ameritech's COE plant investment balance. The ASD's audit procedures were inadequate and incomplete, as evidenced by the ASD's failure to conduct corroborating testing of internal controls, support documentation and other supplemental evidence, and general ledger account balances. The conclusions reached and recommendations offered by the ASD in its Audit Report cannot be relied upon - such conclusions and recommendations can only be made based on audits performed in accordance with authoritative standards and practices.
- ASD's Methodology Used to Re-score "Not Found" Items -- the ASD in its Public Notice claims that "The field audits were physical inspections conducted under generally accepted government auditing standards."⁴ The procedures followed by ASD to re-score "not found" items, however, focused only on the gathering of "probative evidence," a restrictive and arbitrary standard, and did not take into account several aspects of generally accepted government auditing standards ("GAGAS"), deficiencies with respect to GAAS aside, necessary to render a fair evaluation of the COE account balances. Such critical deficiencies included ignoring evidential matter obtained from independent sources and the failure to review internal controls over the hardwired COE CPR process in order to properly determine the validity and reliability of the numerous types of supplemental evidence submitted to ASD by the Company.
- The Need for Simplification of the FCC's Property Record Requirements -- the ASD narrowly interpreted its CPR rules to the detriment of the Company. The FCC's property record rules are overly detailed given the changes in regulation, technology and competition and should be simplified.

⁴ Public Notice, p. 1.

These deficiencies, together with the deficiencies identified in the Company's complete response, show that the ASD's audit procedures, conclusions and recommendations are flawed and cannot be relied on to form an opinion on the fair presentation of the Company's COE account balances (See Attachment C of Ameritech's September 23, 1999 Comments in this proceeding, Appendices A-0 through A-5).

SUFFICIENCY OF THE ASD'S AUDIT PROCEDURES

Analysis of Authoritative Auditing Standards

Generally Accepted Auditing Standards

The ASD states in its Public Notice that the audit was conducted in conformance with GAGAS, which are claimed to be comparable to GAAS. In fact, GAGAS address the standards for auditing government organizations, programs, activities and functions, and of government assistance received by contractors, nonprofit organizations and others. Therefore, GAGAS are concerned with how the government, its agencies and other entities receiving government funds should be audited and not how a government agency performs an audit. GAGAS are not focused on how to conduct audits of the fair presentation of financial statement information, as is the case with GAAS, especially in regards to financial statements presented in accordance with GAAP.

Since the ASD draws conclusions about the fair presentation of COE plant account balances and recommends adjustments to such plant balances, such recommendations can only be made based on audits performed in accordance with GAAS.

Even if one were to assume that both sets of standards are very similar *then* the conformance to those standards must be reviewed with a critical eye. GAAS (and even GAGAS) would not sanction some of the major shortcomings of this audit in planning and execution as discussed below.

Performance of Individual Audit Procedures Such as Physical Verification

Under GAAS, audit procedures related to a specific account balance or class of transactions cannot be considered in isolation in forming a conclusion with respect to such account balance or group of transactions. This is because audit procedures performed related to other financial statement accounts might also provide evidence relative to the fair presentation of the account balance in question. For example, tests of the propriety of the balance in accounts payable may provide evidence with respect to the proper recording of both telecommunications plant and expense transactions. Such tests provide audit evidence with respect to both the debits and credits recorded in the Company's general ledger.

GAAS also require that the auditor design the audit plan "to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming

an opinion.”⁵ “Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor.”⁶ Audit results should take into account the results of various procedures performed and evidential matter gathered. No individual audit procedure is necessarily indicative of a material misstatement in an account balance or class of transactions - other corroborating evidence must be obtained. Without such evidence, it would be inappropriate for the auditor to conclude with respect to the fair presentation of an account balance such as telecommunications plant.

Audit Evidence and Communications with Management

As noted above, GAAS require the auditor to investigate all information that he or she becomes aware of, including information provided by management, during the audit process. With respect to all information provided, the auditor must determine:

- whether the information is reliable and factual,
- if the facts existed at the date of the audit report and whether it is likely that users or likely users of the report would attach importance to the new information, and
- whether appropriate disclosures of such facts should be made to the users or likely users of the audit report. If the effect on the financial statements or auditor's report of the information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report.

In other words, an important source of audit evidence is Company management. As the ASD auditors were only in the field one day per central office location, it is conceivable that not all assets could be located or physically verified. An audit is not a "one chance and one chance only" proposition, however. To the extent that management was able to find the sampled equipment subsequent to the auditors' field work or obtained reasonable support documentation to refute a "not found" determination, such additional evidence should be considered in the same light that the physical verification results were considered. **It is inconceivable and contrary to conventional auditing practices that the ASD staff did not perform follow-up field visits in order to verify hardwired COE that was found subsequent to their one-day visit.** It is equally inconceivable that the ASD largely ignored the physical verifications performed by Arthur Andersen (See Attachment B of Ameritech's September 13, 1999 comments in this proceeding).

Further, to perform an effective audit, audit results should be discussed with management to ensure that the auditor has obtained the best evidence possible and reached the appropriate conclusions. AA's firmwide auditing policies require the audit

⁵ AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter, "Sufficiency of Evidential Matter."

⁶ AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter, "Nature of Evidential Matter."

team to discuss preliminary findings with management and, if management presents evidence that contradicts the audit findings and can be verified, the audit team should modify the results to reflect the newly received evidence.

During the ASD's audit process, communications were extremely limited thus depriving the ASD of the benefits of management's insight and input to the audit process and results. Only upon the insistence of the Regional Bell Operating Companies ("RBOCs") were draft audit results released in July 1998. Even then the dialogue between the ASD and the RBOCs was limited. The RBOCs were permitted only to:

- "Comment on the specific findings addressed in the enclosed draft report and listings, limited to correction of factual errors or omissions"⁷ in response to the ASD's July Report, and
- "Provide specific comment on the enclosed audit report, limited to a total of 50 pages (including attachments, if any)"⁸ in response to the ASD's December Report.

This dialogue, which occurred only upon the insistence of the Company and the other RBOCs⁹, was not the two-way communication necessary to interpret and resolve audit findings and conclusions in this complex area.

Generally Accepted Government Auditing Standards

GAGAS does prescribe relevant standards pertaining to audit quality and the characteristics of professional and meaningful audit reports. GAGAS, codified in Government Auditing Standards,¹⁰ specifies the following requirements that were not followed by the ASD in conducting its CPR audits:

- Auditors should obtain a sufficient understanding of internal controls to plan the audit and determine the nature, timing and extent of tests to be performed.¹¹ These CPR audits consisted solely of the physical verification of certain hardwired COE items from the CPRs - the Company's internal controls over COE plant assets were not considered in determining the nature, timing and extent of audit tests to be performed.

⁷ FCC Draft Audit Report, "Audit of the Continuing Property Records of Ameritech As of July 31, 1997, Report of Audit Findings" issued July 27, 1998 (hereinafter referred to as the "July Report").

⁸ FCC Draft Audit Report, "Audit of the Continuing Property Records of Ameritech As of July 31, 1997" issued December 22, 1998 (hereinafter referred to as the "December Report").

⁹ See Letter to Ms. Kathryn C. Brown, Chief, Common Carrier Bureau from Kathleen Q. Abernathy, U S WEST, Inc. dated July 2, 1998 at Arthur Andersen attachment (Letter to Ms. Kristine M. Ringsdorf, U S WEST, Inc. dated June 26, 1998, from Carl R. Geppert).

¹⁰ Government Auditing Standards: 1994 Revision, issued by the United States General Accounting Office, Comptroller General of the United States (June 1994) [hereinafter Yellow Book].

¹¹ Yellow Book, ¶ 4.21.

- Auditors should establish clear criteria used to determine whether audit objectives are achieved. Criteria provide a context for understanding the results of an audit. The audit plan, where possible, should state the criteria to be used.¹² Despite repeated requests by Ameritech and the other RBOCs, the ASD never disclosed its audit standards or criteria used to assess whether assets were "found" or "not found" until the release of the Public Notice on April 7, 1999 (almost one and a half years after the dates of the physical verifications and one month after the release of the Audit Report).

Standards of review must exist so that all persons conducting the audit and interpreting its results understand the criteria to determine if an item is "found" or is "not found" and the financial implications of such a finding. These standards, or guidelines, should be clearly documented and communicated prior to the execution of testing so that all parties have a common understanding of what will constitute a compliant item. If the ASD's scoring and re-scoring criteria were known in advance, as is the normal procedure in conducting an audit, the Company could have gathered the appropriate audit evidence in accordance with such requirements. At a minimum, knowledge of the ASD's scoring and re-scoring standards would have facilitated a more efficient, if not more accurate, process of (1) physically verifying the existence of the sampled items, (2) gathering additional documentation to evidence the existence of sampled COE items (by the Company), and (3) reviewing and evaluating the reliability and validity of such documentation (by the ASD).

- "Auditors should report the views of responsible officials...concerning auditors' findings, conclusions and recommendations."¹³ These rules go on to state that, "One of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible auditee officials and others, as may be appropriate. Including the views of responsible officials produces a report that shows not only what was found and what the auditors think about it but also what the responsible persons think about it and what they plan to do about it."¹⁴

In addition, these rules require the auditor to evaluate management's comments on the audit findings and *modify the findings if necessary*. "When the comments oppose the report's findings, conclusions or recommendations, and are not, in the auditors' opinion, valid, the auditors may choose to state their reasons for rejecting them. Conversely, the auditors should modify their report if they find the comments valid."¹⁵ As discussed below, the ASD set a standard requiring any additional evidence to have "strong probative value equal to the physical inspection evidence."¹⁶ It is interesting to note, however, that the ASD's standards did not include the physical re-verification of assets, even though the ASD states (correctly) in the Public Notice that "the best evidence that verified whether an item was

¹² Yellow Book, ¶ 6.11.

¹³ Yellow Book, ¶ 7.38.

¹⁴ Yellow Book, ¶ 7.39.

¹⁵ Yellow Book, ¶ 7.42.

¹⁶ Public Notice, p. 2.

accurately recorded in the CPRs was the auditors' physical inspection during the field audits."¹⁷ The obvious question that begs to be answered here is -- why didn't the ASD auditors ever go back into the field to re-verify their initial physical inspection results and/or validate the supplemental evidence as to the asset's existence provided by the Company?

- "The [audit] report should be complete, accurate, objective, convincing, and as clear and concise as the subject permits."¹⁸ Regarding objectivity, GAGAS standards go on to state that "Objectivity requires that the presentation of the entire report be balanced in content and tone. A report's credibility is significantly enhanced when it presents evidence in an unbiased manner so that readers can be persuaded by the facts."¹⁹

Analysis of the Adequacy and Completeness of ASD's Audit Procedures

Our analysis of the adequacy and completeness of ASD's audit procedures was contained in Appendix A to the Company's response to the December Report.²⁰ This analysis incorporates much of the same material submitted in conjunction with the Ameritech Response.

The ASD's methodologies for conducting its audits and evaluating additional evidence are detailed in the Audit Report and the Public Notice. As described in the Public Notice and the Audit Report, the ASD's primary audit procedure in attempting to assess the accuracy of the Company's CPRs was a physical inspection of sampled hardwired COE listed on the CPRs. While physical verification audit procedures often serve as an effective substantive test of the fair presentation of telecommunications plant account balances, the results of such procedures should be considered in conjunction with other audit evidence in forming a conclusion with respect to the fair presentation of plant account balances. Physical plant verification procedures must be executed carefully; however, due to the high volume of plant transactions processed in the accounting records at a company the size of Ameritech.

In performing its physical verification procedures, the ASD staff stated that its objectives were: "to determine whether Ameritech is in compliance with the Commission's requirements regarding basic property records and continuing property records, as set forth in sections 32.2000(e) and (f) of the Commission's rules, and to determine whether Ameritech's plant accounts accurately reflect the cost of assets used and useful in the provision of telecommunications services."²¹ The ASD did not meet its objectives in several critical respects, as discussed below. These failures result in unreliable conclusions and recommendations.

¹⁷ Public Notice, pp. 1-2.

¹⁸ Yellow Book, ¶ 7.50.

¹⁹ Yellow Book, ¶ 7.57

²⁰ See Attachments A-0 through A-4, to "Comments of Ameritech on December 22, 1998 Draft Audit Report of Ameritech's Continuing Property Record (CPR)," dated January 11, 1999 (hereinafter referred to as the "Ameritech Response").

²¹ Audit Report, p. 5.

- ASD statistical sampling methodologies -- the ASD used a sampling technique ("attribute sampling") that is appropriate to verify the existence of items (i.e., compliance of certain attributes with the FCC's rules) but inappropriate for use to ascertain the value of any missing items. A variables sampling method designed to test investment dollars, not items, would have provided the proper basis for extrapolation of potential over- or understatements of plant account balances. If the ASD had used a variables sampling method, such a method would most certainly have involved a stratification of the population of hardwired COE investment with both a greater focus on high-dollar COE items and a greater focus on newer equipment. The ASD's sampling method, however, resulted in smaller dollar value items being as or more likely to be selected in the sample.

Unfortunately, a variables sampling method was not planned or performed by the ASD staff and cannot be applied post-facto by the ASD nor can it be overlaid upon an attribute sampling method to achieve more than one audit objective. If the ASD wanted to arrive at reliable estimates of the accuracy of plant account balances, it should have designed the audit in a significantly different fashion that considered the in-place cost of the equipment and used dollar-based selection techniques.

Since the ASD only performed a physical verification of CPR records using attribute sampling, only the objective related to the Company's compliance with the FCC's property record requirements could be satisfied. This objective would only be satisfied, however, if the audit was administered and executed properly and without bias (which it was not as explained further below). Since the ASD staff only performed a one-way verification test, such verification was biased in that it would only detect possible instances of CPR record overstatements. In other words, the ASD did not **plan** its audit procedures to: (1) draw a statistically valid conclusion with respect to the fair presentation of COE plant account balances, and (2) look for both potential over- and understatements of plant balances. This could only have been accomplished by planning and performing a "two-way" audit.

- No consideration for understatement -- As noted above, the ASD's physical verification procedures were solely directed at detecting instances of potential overstatement in the plant accounting records. Instances of potential understatement were not considered. In other words, the ASD's physical testing procedures would only reveal instances where COE items included on the July 31, 1997 CPRs were not in the specified location as detailed in such CPRs. A comprehensive test of the physical existence of plant assets would not only consider instances of potential overstatement, but would include procedures such as the selection of assets in the respective central offices and the tracing of such assets to the CPRs to ensure that the CPRs are not understated. Only by testing for both potential over- and understatements can one begin to form the basis for concluding as to the propriety of the telecommunications plant account balances.
- Restrictive field audit procedures -- In addition to the above flaws in the physical verification test design, the field audit procedures followed appear to have been

restrictive. Per discussions with Ameritech personnel, the ASD auditors were on-site in each location for a period of one day - there were no subsequent follow-up visits to any of the 34 central office locations. Thus, Company personnel were only given a limited amount of time to locate the sampled COE items that the ASD staff was attempting to physically verify. This limited window of time seems inadequate, particularly considering the fact that certain items of COE tend to be small and "built-in" to other assets, thus making these assets difficult to find. To the extent that sampled items were physically located after the fact, Company personnel stated that the ASD staff was generally unwilling to consider such findings in their results.

- No adjustment for timing differences -- The ASD staff utilized Ameritech's CPRs related to COE as of July 31, 1997 as the population from which the sample items to be verified would be selected. The physical verification of such equipment items did not occur, however, until November 1997. There were no procedures performed, normally termed "cutoff procedures," to account for any plant additions, retirements, adjustments, etc. that may have occurred during the time period from July 31, 1997 to the date of the physical verification. Thus, to the extent that the ASD staff could not find equipment at the central office location during its physical verification, it is certainly possible that such plant could have been retired subsequent to July 31, 1997 but prior to November 1997. Classification of such items as "not found" would be clearly inappropriate in this instance. Ameritech had three sampled items that were retired between July and November 1997 that were originally scored a "3," not found. Ameritech noted that signed documentation in support of such retirements was sent to the ASD in February 1998 and again in August 1998. Re-scoring did not occur until December 1998.
- Failure to verify Ameritech's supplemental evidence -- In response to the ASD's July and December Reports, AA and Ameritech personnel have supplied the ASD with supplemental information that indicated over 80% of the items classified as "not found" or "unverifiable" by the ASD's physical verification team were inappropriately classified as such. The evidence submitted by AA and Ameritech indicated that ASD's results were inaccurate for reasons including the following: (1) assets had been physically located, (2) assets were determined to have been physically removed (but the retirement had not been reflected on the CPR), and (3) credit had not been given for items partially found. In the instances that Ameritech found the CPR to be incorrect, adjustments were made to the CPR. At a minimum, this additional documentation should have warranted a follow-up visit by the ASD to certain central offices to validate this additional evidence and/or follow-up discussions with Ameritech personnel. See discussion of the validity and reasonableness of ASD's re-scoring methodology below.
- Failure to review accounting records -- Finally, it should be noted that the ASD audit concentrated only on the CPRs and not the COE plant account general ledger balances. It seems unreasonable to conclude that the Company's hardwired COE investment is overstated when the accounting records evidencing such investment were not reviewed. To the extent that adjustments had been made to the accounting records and not to the supporting CPR detail, for instance, the audit would not have

detected such adjustments which obviously would impact any conclusion with respect to the fair presentation of the accounting records.

The ASD's recommendation that Ameritech write-off \$306.0 million of hardwired COE is fundamentally flawed. This write-off amount was determined by extrapolating the results of the ASD's sample physical verification procedures to the entire hardwired COE population. Since Ameritech has submitted evidence that the ASD's findings are inaccurate, the extrapolated amount is too high. In addition, the extrapolation calculation is based only on CPR items that were (in the ASD's opinion) overstated, and no consideration was given to understatements, which would impact (reduce) the extrapolation. Finally, in a statistical sample, one can only estimate errors within a range of confidence. In other words, sampling can only result in a statement such as: "I believe that the actual value of plant assets is between \$1 billion and \$2 billion with a 95% degree of confidence." Statistical theory states that no single value within such a range is any more likely to be correct than any other. Therefore, even if one assumes that the ASD's statistical methods and audit procedures were sufficient, the lower end of the confidence interval is the only justifiable amount that could be proposed as an adjustment to the account balances, no matter what the underlying statistical methodology.²²

ASD'S METHODOLOGY USED TO RE-SCORE "NOT FOUND" ITEMS

Evaluation of ASD's Re-scoring Standards and Methodology

The ASD's audit procedures for reclassifying or "re-scoring" field audit findings were first disclosed in the April 7, 1999 Public Notice. In the Public Notice, ASD gives a lengthy explanation of its re-scoring standards, stating that:

In order to warrant a change in scoring, this additional evidence had to have strong probative value equal to the physical inspection evidence. Carriers were advised to provide adequate and convincing documentation that would make clear that the actual condition was different from what appeared to the auditor at the time of physical inspection. In response, the carriers provided a range of documentation requesting scoring changes.²³

There are several problems with not only the re-scoring criteria applied by the ASD but the manner by which re-scoring took place. It is no wonder that the ASD received a broad range of documentation requesting scoring changes, as the ASD never disclosed to or discussed with the RBOCs their re-scoring standards or the specific documentation needed to meet the above "probative evidence" standard. Thus, the Company and other RBOCs were left to interpret such re-scoring criteria themselves. As authoritative auditing literature does not prescribe specific evidentiary standards for the evaluation of support documentation, the Company was left with no other choice than to judgmentally evaluate the documentation accumulated and assess its reasonableness.

²² "Statistical Models and Analysis in Auditing," Statistical Science, v. 4, no. 1, pp. 10-11.

²³ Public Notice, p. 2.

The ASD clearly imposed strict evidentiary standards in its review of support documentation but neglected to perform the most basic, and most persuasive, of audit procedures to verify the accuracy of such documentation and the existence of the assets in question. The auditors never returned to the field to re-verify its scoring by physical inspection or discussed the results of their scoring with the appropriate Ameritech personnel. The existence of additional audit evidence should at a minimum give rise to procedures to validate such information. Such procedures cannot properly be performed "in a vacuum" by the ASD but rather must involve interaction with Company personnel where the merits of the additional audit evidence can be discussed and interpreted. This is especially necessary given the different forms of documentation maintained by the individual RBOCs, where different forms of documentation may be used differently from one company to the next in support of plant accounting entries.

The ASD's "probative evidence" standard is not a term of art in the auditing profession and prescribes a standard over and above that suggested by GAAS. GAAS addresses the concepts of sufficient, competent evidential matter as follows:

To be competent, evidence, regardless of its form, must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various kinds of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:

- a. When evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity.
- b. The more effective the internal control, the more assurance it provides about the reliability of the accounting data and financial statements.
- c. The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.²⁴

The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his or her professional judgment after a careful study of the circumstances in the particular case. However, in the great majority of cases, the auditor has to rely on evidence that

²⁴ AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter, "Competence of Evidential Matter."

is persuasive rather than convincing...even an experienced auditor is seldom convinced beyond all reasonable doubt with respect to all aspects of the statements being audited.²⁵

Several key concepts from the preceding excerpts should be highlighted. First, GAAS recognizes that the nature and extent of audit evidence will vary among audits and that proof "beyond a reasonable doubt" will rarely be obtained. Thus, the ASD's "probative evidence" standard in the real world will rarely, if ever, be achieved. What GAAS (as well as GAGAS) then directs the auditor to do is obtain additional persuasive evidence - not ignore the documentation supplied because it doesn't meet, in the ASD's interpretation, this arbitrarily high standard.

Second, GAAS recognizes that many different types of evidence are available to the auditor. While some types of evidence are more reliable or persuasive than other types, all evidence should be considered and appropriate steps taken to validate such evidence in support of the audit opinion rendered. GAAS speaks to the auditor's ability to build a reasonable, persuasive case in order to positively opine with respect to the fair presentation of an account balance, rather than evaluate evidence against an artificially high standard in order to produce negative findings.

Third, the ASD cites criterion c. above in the Public Notice in its discussion of the evidence gathered in these CPR audits. However, the ASD largely ignored criteria a. and b. above in performing its audits and evaluating supporting documentation submitted by the companies. With respect to criterion a. above, AA performed tests of physical verification and support documentation in conjunction with Ameritech's response to the July Report. The results of such testing are summarized below. The ASD, however, largely ignored the work performed by AA in developing its final audit report.

Further, the ASD did not review internal controls over the hardwired COE CPRs in order to determine the nature, timing and extent of audit testing to be performed. In addition, the ASD didn't develop a proper understanding of the COE internal control environment in order to provide the basis for the evaluation of specific audit evidence and audit results. A review of internal controls not only could have influenced the nature and scope of audit testing procedures performed by the ASD in its audit, but it would have provided the ASD a sound basis for accepting or rejecting various types of supporting documentation supplied by the companies. For example, had the ASD reviewed the controls over Ameritech's retirements process, including key systems used in the retirement of COE assets, and found them reliable, then reliance on computer generated documentation of COE retirements as valid supporting documentation would clearly have been justified. By failing to review internal controls over COE-related processes, the ASD failed to justify any standard for review of support documentation.

²⁵ AICPA, Statements on Auditing Standards, AU Section 326: Evidential Matter, "Sufficiency of Evidential Matter."

As discussed above, many deficiencies were noted with respect to ASD's compliance with GAGAS, which standards were supposedly followed by ASD in performing its audits and evaluating additional support documentation. Standards of review must exist so that all persons conducting the audit and interpreting its results understand the criteria to determine if an item is "found" or is "not found" and the financial implications of such a finding. These standards, or guidelines, should be clearly documented and communicated so that all parties have a common understanding of what will constitute a compliant item. If the ASD's scoring and re-scoring criteria were known in advance, as is the normal procedure in conducting an audit, the Company could have gathered additional audit evidence in accordance with such requirements. Additionally, the Company could have provided documentation and/or explanations along with the evidence submitted in order to prove that such evidence was "probative" in nature. At a minimum, knowledge of the ASD's re-scoring standards would have facilitated a more efficient, if not more accurate, process of both gathering additional documentation to evidence the existence of sampled COE items (by the Company) and reviewing and evaluating the reliability and validity of such documentation (by the ASD).

As a result, ASD's re-scoring standards and methodology were deficient with respect to the timing of their communications to the auditee, the restrictive and arbitrary use of the "probative evidence" standard, the disregard of pertinent authoritative standards for the determination of sufficient and competent evidential matter, and the failure of ASD to review internal controls in order to determine what evidence could be relied on. Such deficiencies render the re-scoring process and the audit results determined therefrom unreliable.

Results of AA's Re-scoring and Re-verification Procedures

In conjunction with Ameritech's response to the July Report, AA performed certain re-verification and re-scoring procedures. These procedures were similar in many respects to those described in the Public Notice with two important exceptions:

- AA physically verified the existence of equipment classified as "not found" by the ASD, where possible, and
- AA reviewed relevant support documentation and discussed the validity and adequacy of such documentation with Ameritech management to ensure that the information was properly interpreted.

The procedures performed and results achieved are detailed in Appendix A-4 to the Ameritech Response. Our review focused on high-dollar value items classified by the ASD as "not found." Of the 38 items reviewed, AA was able to physically verify 15 items and substantiate the CPR value and quantity through review of supplemental information of an additional 5 items.

As discussed herein, significant flaws in the FCC's audit procedures and underlying sampling methodologies were revealed, thus rendering the FCC's

preliminary audit results unreliable. Conclusions should not be drawn with respect to the fair presentation of Ameritech's hardwired COE investment based on the procedures performed by the FCC staff. The impacts of the above results on the extrapolated error amount contained in the FCC's draft report are summarized as follows:

<u>Revised Count</u>	<u>Extrapolated Error per FCC</u>	<u>Revised Extrapolated Error</u>
Number of Items "Not Found"	140	108
Dollar Amount of Items "Not Found"	\$936,046	\$516,287
Extrapolated Error (Point Estimate)	\$358.1 Million	\$182.6 Million
Variance of Extrapolated Error	+/- \$125.6 Million	+/- \$88.9 Million
Low-End of COE Estimated Error	\$232.5 Million	\$93.7 Million

The above comparisons should be modified to reflect the ASD's reduction of the extrapolated error amount from \$358.1 million in the July Report to \$306.0 million in the December Report. In other words, the "revised Extrapolated Error" amounts presented above should likely be lower to reflect the ASD's December adjustments. Because of a number of issues involving the FCC's sample design, implementation, technique and logic, there is no basis to extrapolate beyond the lower bound of the point estimate of \$93.7 million (reduced as appropriate to reflect the ASD's December 1998 adjustments).

In addition to the procedures performed by AA as described above, Ameritech compiled extensive documentation regarding the ASD's CPR audit scoring inconsistencies. Ameritech's documentation illustrates many examples where certain sample items were re-scored based on supplemental documentation submitted, whereas other similar items were not re-scored even though identical or similarly provided information was submitted.²⁶ This haphazard and apparently arbitrary re-scoring further demonstrates the importance of clearly communicating the standards against which the Company was to be judged.

SIMPLIFICATION OF FCC RULES AND REGULATIONS

The intent of the Telecommunications Act of 1996 ("1996 Act") was to create a competitive marketplace in the communications industry. To that end, regulations should ultimately be eliminated, and the local exchange carriers ("LECs"), including the RBOCs, should be free to manage their operations in a manner that promotes competitive initiatives. The FCC is required by the 1996 Act to review its accounting regulations every other year, beginning in 1998. The 1996 Act intended this requirement to eliminate rules that are no longer useful in regulating the telecommunications industry. There are sufficient regulations imposed by the Securities and Exchange Commission ("SEC") and other legislation (e.g., Foreign Corrupt Practices Act) which protect consumers' and shareholders' interests. All companies in the United States must abide by these regulations, and to place additional regulatory burden on the LECs is anti-competitive. Furthermore, the rules defined in Section 32.2000 of the FCC's Rules

²⁶ See Letter to Mr. Bob Hood, Acting Chief, Audits Branch, from Ms. Robin Gleason, Ameritech, dated February 16, 1999.

and Regulations are obsolete in that they were designed to determine tariffed rates under traditional rate of return regulation.

The FCC's Property Record Rules Should Be Simplified

In July and November 1998, AA, in association with several large LECs, filed with the FCC two reports which illustrated numerous opportunities for the FCC to eliminate or modify regulations which are no longer serving a useful purpose.²⁷ Several opportunities identified by AA pertained to regulations governing property accounting, including maintaining overly detailed CPRs, as well as the unduly cumbersome requirement to track all costs regardless of their amount. AA also recommended that the FCC reduce the level of detail currently required to be maintained in the CPR, such as detailed plant subaccount, record category and bay/shelf/rack location. In addition, the FCC should allow Ameritech and other telecommunications providers subject to the Part 32 Rules and Regulations to define and track property units at a level necessary to manage the business and to be able to set its own depreciation rates/lives without oversight by the FCC.

AA further recommended that the FCC allow an expense limit on COE and other telecommunications plant, just as it allows for certain general purpose equipment. The current requirement that Ameritech and other local exchange carriers track all COE, regardless of cost, is excessively costly and unnecessary. As discussed above, the ASD selected 1,224 items for its audit. Of the 1,224 items, 442 items (36.1%) (excluding the 49 items that had an in-place cost of zero) had a cost below \$2,000 per item. The total value of the 442 items, however, was only 2.9% of the total dollar value of the 1,224 items. Furthermore, 4 and 46 items had a cost below ten and one hundred dollars, respectively. The cost incurred by Ameritech to maintain CPRs for these items clearly outweighs any conceivable benefit derived from maintaining CPRs for these assets.

The FCC Property Record Rules Exceed GAAP and Other Industry Requirements²⁸

All companies, including the RBOCs, must maintain sufficient internal controls in order to safeguard assets and ensure that their financial accounts and records are accurately stated as prescribed by rules promulgated by GAAP, the SEC and the Internal Revenue Service. Pursuant to GAAP, companies are required to maintain an internal control structure that provides for the verification of asset balances in support of amounts presented in the financial statements. GAAP requires that assets be accounted for at their original cost, tracked (on an original or average cost basis) as to location, depreciated over their estimated economic useful lives, and retired from the books of account on a timely basis. The realizability of plant assets (in the form of future revenues expected to be generated from such assets) must also be assessed and an

²⁷ "Accounting Simplification in the Telecommunications Industry," Prepared by Arthur Andersen LLP, July 15, 1998, and "Supplement to July 15, 1998 Position Paper," Prepared by Arthur Andersen LLP, November 10, 1998 (hereinafter referred to as the "Arthur Andersen Paper").

²⁸ See Arthur Andersen Paper at pages 25-37 for a more detailed discussion.

impairment loss recorded if the future cash flows to be generated from the use of such assets are less than their current net book value.

Other industries have far less restrictive property record requirements than those imposed on the incumbent LECs by the FCC. These differences are driven primarily by the fact that the level of detail maintained by nonregulated entities in their property records is primarily driven by the information needs of management, whereas the LEC property records are driven by the regulatory requirements contained in Section 32.2000 of the FCC's Rules. The primary difference lies in the number of property units maintained - nonregulated entities track property units at a level of detail that allows management to manage its assets and run the business most effectively. This same guiding principle should be used to establish less detailed property record requirements for the LECs, including the RBOCs.

The property record requirements of other regulated companies are also more flexible and less rigorous than the FCC's Section 32.2000 Rules and Regulations. The Federal Energy Regulatory Commission ("FERC") has taken steps during the past two years to relieve the electric, gas, water and natural gas pipeline companies subject to its jurisdiction of overly-burdensome property record requirements. The FERC has allowed the utility companies to redefine property units, set expense limits based on materiality instead of setting predetermined limits for the companies, and has redefined the audit process to be more exception-based. These changes were made cooperatively by the FERC, working with the utility companies subject to its jurisdiction, even though such companies were still subject to traditional cost-based regulation.

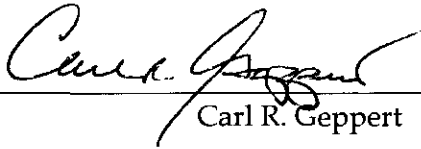
CONCLUSION

In summary, the ASD's limited physical verification audit procedures were not sufficient to form an opinion, in accordance with GAAS, as to the fair presentation of the Company's hardwired COE plant investment. ASD's reliance on GAGAS was both misstated and narrowly selective and is insufficient to compensate for those provisions of GAAS not used in the audit plan or execution. Specifically, ASD's failure to conduct corroborating testing of internal controls and ledger account balances and their failure to completely and consistently evaluate the significant evidential matter submitted by the Company and external sources, including Arthur Andersen, together with previously identified audit deficiencies, render the audit findings, conclusions and recommendations unreliable. Additional quality control procedures over the physical verification tests that were performed as well as additional compliance and/or substantive audit procedures would be necessary to render an opinion on the fair presentation of Ameritech's COE account balances pursuant to GAAS.

This concludes my declaration.

Pursuant to 47 C.F.R. Section 1.16, I declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed this 23rd day of September 1999.



Carl R. Geppert

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